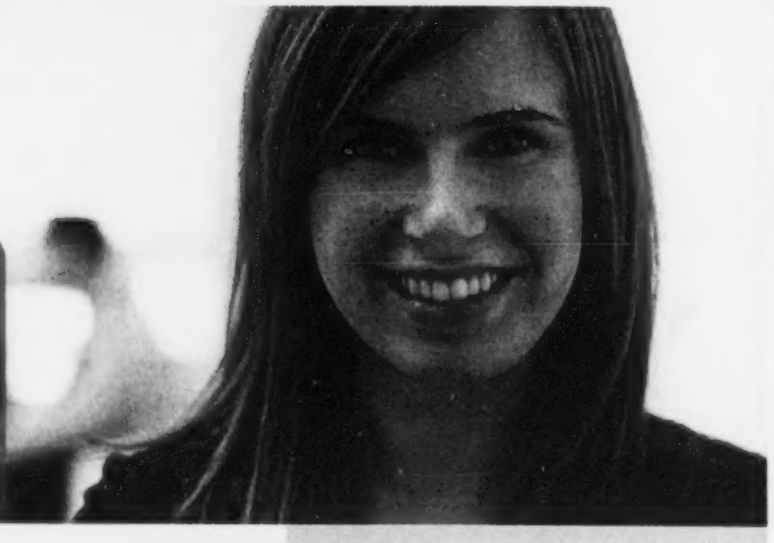
BDC
Entrepreneurs first

economic LETTER

SEPTEMBER 2011



CANADA AND THE GLOBAL FINANCIAL CRISIS

In the wake of the financial crisis that shook the world in 2007 and 2008 and triggered a serious global recession, the G-20 countries put forward two proposals. The first was to reform the international financial system in order to avoid another such crisis, and the second was to take steps to consolidate the recovery and achieve sustainable and balanced global economic growth.[1]

The first initiative led to the creation of new international banking standards known as Basel III, which will start to come into effect in January 2013 and be fully in place by 2019. The main new measures involve:

1. limiting financial leverage;
2. increasing and improving the loss-bearing capital that financial institutions must hold;
3. establishing a liquidity ratio to help them weather a liquidity crisis.

These new standards should strengthen the international financial system but may not be able to prevent knock-on effects similar to those caused by the failure of high-risk mortgage loans that were at the root of the financial crisis. Some of the work has been done, but it will take a lot of effort to improve the system even more.

The second initiative, developed in 2009 just as the global economy began recovering, led to the formulation of a three-pillared policy package:

1. fiscal consolidation in advanced countries;
2. in emerging countries, a strengthened social safety net, infrastructure development and, in some cases, increased exchange rate flexibility;
3. and for the entire G-20 membership, the pursuit of structural reforms to improve growth prospects.

Recent events, particularly the sovereign debt crisis in Europe and the downgrading of U.S. debt, show how hard it will be to implement this program, especially the fiscal consolidation aspect. In addition, the interest rate flexibility component clearly targeted China, whose currency is still undervalued against the U.S. dollar. This undervaluation of the renminbi is slowing growth in the United States, fuelling inflation in China and inducing other countries to intervene to influence the price of their currency, which is making global imbalances worse. ▼

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> **Employment dips slightly**
> **Trade deficit shrinks**
> **Housing starts down**
> **Corporate profits could decline**

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1 The main source for this letter is a speech given by the Senior Deputy Governor of the Bank of Canada, Tiff Macklem, in Mumbai on August 24 2011.

Canada will not have to do much to meet the Basel III standards. Canadian banks are already among the best capitalized in the world. In the past three years the Canadian banking system was rated the best in the world by the World Economic Forum. Also, Canada will not have too much difficulty complying with the program to foster sustained global economic growth, partly because its fiscal situation is much healthier than that of most other advanced countries. As a small but globally-oriented economy, it is in Canada's interest that the reform of the international banking system be completed and that every country follow the program aimed at achieving sustained global economic growth. However, Canada must continue to walk the talk since the stability of its financial system and its relatively healthy fiscal situation are the main reasons it weathered the global financial crisis better than most other G-20 countries. ■

CANADA

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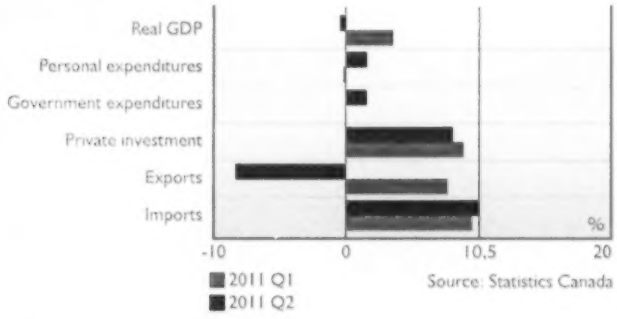
Recent economic data point to slowing economic growth. Real GDP declined in the second quarter, job creation has run out of steam in the past few months and corporate profits could decline. These results are largely due to the slowdown in the global economy and particularly the American economy. On the plus side, domestic demand remains strong and the labour market slowdown is not alarming since it follows strong employment growth since the beginning of the year. Therefore, we still have reason to be optimistic, even though the risk of the impact of a more severe slowdown in the global economy on Canada cannot be ignored.

Real GDP declines in the second quarter

Real GDP declined 0.4% in the second quarter from the previous quarter. This decline is wholly attributable to lower net exports resulting from an 8.3% drop in exports coupled with a 10.0% rise in imports. The growth in domestic demand in fact accelerated from 1.8% in the first quarter to 3.0% in the second; after marking time in the first quarter, consumer and government spending rose again while private investment continued to grow at almost the same pace as in the previous quarter. Growth – and especially exports – was adversely affected by specific events such as the forest fires in Alberta, which slowed oil production, and the tsunami in Japan that reduced the production of vehicles and auto parts. These effects should be reversed in the next quarter, but exports could continue to suffer from the weakness in the U.S. economy.

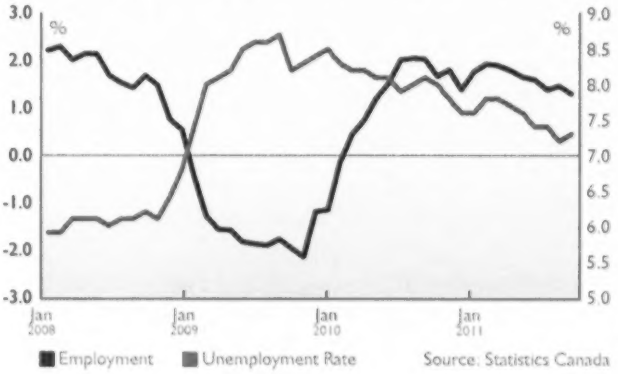
Quarterly growth, at annual rate, of the main GDP componants



Employment dips slightly

After gaining 7,100 jobs in July, the labour market lost 5,500 in August. This is clearly a downturn from the first half of 2011 when 191,800 jobs were created at an average of 32,000 per month. In August, jobs were lost in construction and transportation and warehousing, two sectors that had posted strong growth earlier in the year. The natural resources sector also posted its fourth consecutive decline. These losses were offset by increased employment in health care and social services. The unemployment rate edged up from 7.2% in July to 7.3% in August. The slowdown in employment growth is not too worrying for the moment because it is happening mainly in sectors that posted big increases in previous months. That being said, job creation must resume if the unemployment rate is to return to its pre-recession level, which has not happened yet.

Annual Change in Employment and Unemployment Rate



Trade deficit shrinks

With exports growing faster than imports in July (2.2% vs 0.5%), the trade deficit narrowed from $1.4G in June to $753M in July. The sectors that made the biggest contribution to the rise in exports were machinery and equipment, automotive products and industrial goods. On the other side of the ledger, the ▼

strongest growth in imports was in energy and automotive products. Trade with Japan returned to almost the same level it was at before the March tsunami. After a net decline in exports in the second quarter, the July figures on the trade balance are encouraging.

Housing starts down

Housing starts were down from 204,500 units in July to 184,700 in August, a number that is more in line with current demographic factors according to the CMHC. Multiple unit housing starts declined more than those for single family homes (-15.5% vs -0.3%). The CMHC has updated its forecasts for 2011 and 2012. It expects the number of housing starts to remain relatively stable in 2011 and 2012 (at around 183,000 units) and sales of existing homes, which slowed in recent quarters, to hover around their current level until the end of the year and rise slightly in 2012.

Corporate profits could decline

The Conference Board's Leading Indicator of Industry Profitability (LIIP) dipped slightly in August, its first drop since fall 2009. Eighteen of the 49 sectors included in the Indicator were down. In manufacturing, some sectors that depend on exports to the United States, such as lumber, chemicals and metal fabricated products, have posted consecutive declines in recent months. In the service industry, some sectors posted their first decline in August, including home and general insurance, "other financial sectors" and real estate. The LIIP is predictive of movements in corporate profitability six months hence. Since the Indicator is volatile and changes from month to month, several consecutive monthly declines are needed to indicate a clear trend. Therefore, changes in the Indicator must be monitored closely. ■

★ UNITED STATES

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According to recent economic indicators, prospects for the U.S. economy are definitely not good. Job creation has been weaker than expected and the housing market is showing no signs of a sustainable recovery. Also, events surrounding government debt in the United States and Europe – and the resulting turmoil on financial markets – has weakened U.S. business and consumer confidence. The medium term outlook is not very promising.

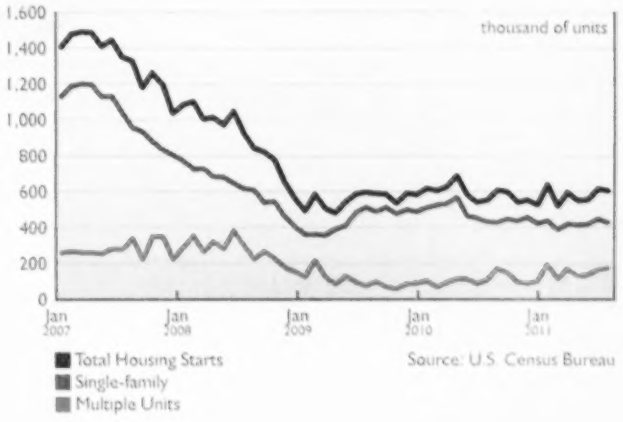
Employment at a standstill

Employment remained unchanged in August, after a weak gain of 85,000 jobs the previous month. The unemployment rate was also stable at 9.1%. The private sector, which had created 157,000 jobs in July, added only 17,000 jobs in August. The data were distorted by a strike by 45,000 employees in the telecommunications sector, but even without this the results would not have been very robust. In short, the labour market is at a standstill. Job creation is anemic and unemployment remains high, which once again confirms the fragility of the economic recovery.

Housing market still depressed

After surging 10.8% in June, housing starts fell back 1.5% in July. Single family home starts were down 4.9% while multiple unit housing starts were up 6.3%. Building permits also declined in July (-3.2%). Sales of existing homes fell 3.5% in July from the previous month and their median price was 4.4% lower than at the same time last year. At the pace of sales in July, it would take 9.4 months to clear the inventory of unsold homes, which is up from the previous month. The housing market is still extremely depressed. Financial institutions are apprehensive and are imposing conditions on potential buyers that stifle demand and push prices down.

Housing Starts



Source: U.S. Census Bureau

Business confidence down, consumer confidence nosedives

The Institute for Supply Management (ISM) Purchasing Managers Index for the manufacturing sector, which reflects the level of confidence of companies in that sector, fell 0.3 percentage points to 50.6% in August. The production component came in below 50%, indicating a contraction for the first time since May 2009. Meanwhile, the U.S. Conference Board's Consumer Confidence Index fell dramatically from 59.2 in July to 44.5 in August, its lowest level since April 2009. Consumers are pessimistic about short-term prospects. Their confidence was definitely shaken by the political debate surrounding the raising of the U.S. debt ceiling. ■

INTEREST RATES

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Key interest rate to remain stable longer than anticipated

On September 7 the Bank of Canada decided to leave the key interest rate unchanged. A few months earlier it had hinted that an interest rate hike was likely if the Canadian economy remained strong. Now it has changed its tune because of the recent deterioration in the global economic outlook, triggered mainly by the worsening of the sovereign debt crisis in Europe and a weaker than expected recovery in the United States. The Bank now expects net exports to remain weak, not just because of the weak global economy but also because of the strong Canadian dollar. Thus the key interest rate is not expected to change any time soon, or at least not before next spring. ■

OIL AND THE LOONIE

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Price of gas continues to fall while the dollar remains quite stable

The price of gas continued its downward trend in the past few weeks due to persistent uncertainty surrounding sovereign debt in Europe and the growth outlook in the United States. Many analysts think the price of crude could have fallen even further but is being buoyed by speculation that the slowdown in the U.S. recovery could induce the Federal Reserve to introduce new support measures. The Canadian dollar has fluctuated in response to financial market volatility in recent weeks, but remained relatively stable compared to gas prices. ■

Crude Oil Price and Canada-U.S. Exchange Rate

SME CONFIDENCE

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Business confidence down sharply

Small businesses have been shaken by the events that rocked the global economy during August and disrupted financial markets. This led to a substantial decline in the CFIB Business Barometer Index, which dropped from 68.3% in July to 61.7% in August, its lowest level since July 2009. Despite this, the numbers are still much more positive than they were during the recession. Confidence was down in most sectors, with the biggest declines in construction, manufacturing, transportation and business services. Also, businesses in Quebec and Ontario seem to have been more affected than those in the other provinces. Small businesses expect inflationary pressures to ease, as shown by lower expectations regarding increases in their selling prices and salaries over the next 12 months. ■

CFIB Business Barometer and Real GDP Growth

(Index of 50 = equal balance of stronger and weaker business expectations)

BUSINESS CREDIT CONDITIONS

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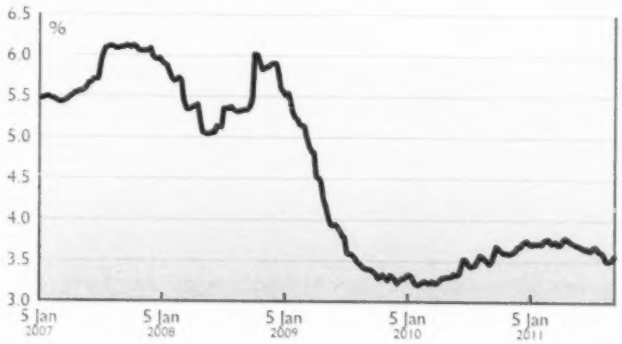
Business credit up sharply

Business credit from chartered banks was 17.1% higher in July than in April. Short-term credit, which accounts for 87% of total credit, grew 17.4% while long-term credit rose 11.0% over the same period. Credit remains very affordable: the Bank of Canada estimates that the effective business interest rate, which is a weighted average of bank and market interest rates for new lending to non-financial businesses, averaged 3.55% in the week of September 2. ■

Effective Business Interest Rate



Source: Bank of Canada

KEY INDICATORS – CANADA

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Key indicators – Canada	Historical				2011				Latest		Forecasts	
	2007	2008	2009	2010	Q1	Q2	Q3	Q4			2011	2012
Real GDP (% growth)	2.2	0.7	-2.8	3.2	3.6	-0.4			Jun	0.2	2.7	2.5
Machinery and Equipment Expenditures (% growth)	4.2	-0.5	-19.5	11.8	15.2	31.0					14.6	8.2
Pre-Tax Corporate Profits (% growth)	1.9	11.0	-33.1	21.2	19.7	-8.4					15.3	7.0
Industrial Production (% growth)	-0.5	-4.5	-9.4	4.6	6.0	-4.9			Jun	0.1	3.8	3.7
Industrial Product Prices (% growth)	1.5	4.3	-3.5	1.0	9.6	4.9			Jul	-0.3	4.5	2.7
Non-Residential Construction (% growth)	2.3	7.9	-22.2	2.8	10.7	2.0						
Housing Starts ('000 units)	229	212	149	192	178	193			Aug	185	178	175
Personal Expenditures (% growth)	4.6	3.0	0.4	3.3	-0.1	1.6					2.3	2.4
Consumer Price (% growth)	2.1	2.4	0.3	1.8	3.6	3.1			Jul	0.2	2.9	2.1
Employment (% growth)	2.4	1.7	-1.6	1.4	2.4	2.0			Aug	0.0		
Unemployment Rate (%)	6.0	6.1	8.3	-3.1	7.8	7.5			Aug	7.3	7.4	7.2
SMEs Confidence Index (CFIB)	67.2	56.1	57.7	66.7	69.2	68.0			Aug	61.7		
Manufacturers Confidence Index (CFIB)	68.8	52.7	56.0	68.6	72.6	71.0			Aug	59.8		

Sources: Statistics Canada, Consensus Economics and Canadian Federation of Independent Business. Annual growth, quarterly growth at annual rate and month-over-month growth.